Report No.
RES11011

London Borough of Bromley

PART 1 - PUBLIC

Agenda
Item No.

Decision Maker:	**Pensions Investment Sub-Committee**
Date:	**10th May 2011**
Decision Type:	Non-Urgent Non-Executive Non-Key
Title:	**INVESTMENT IN PROPERTY**
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Chief Officer:	Director of Resources
Ward:	All

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1. Reason for report

At its meetings on 4th May and 8th September 2010, the Sub-Committee considered the question of investment in property and agreed at the latter meeting that a further report be submitted after 1st April 2011, setting out the issues for further discussion on whether or not property should be included in the Bromley Pension Fund. The report in September included comments from the actuary, Barnett Waddingham LLP, and one of the Fund's managers, Fidelity, who attended that meeting and took part in a general discussion on investment in property. This report updates some of the information previously submitted and recommends that no further action be taken at this time.

RECOMMENDATION(S)

The Sub-Committee is asked to:

2.1 Note the report and agree that no further action be taken on placing Pension Fund investments in property.

Corporate Policy

1. Policy Status: Existing policy. The Council's Pension Fund is a defined benefit scheme operated under the provisions of the Local Government Pension Scheme (LGPS) Regulations 2007, for the purpose of providing pension benefits for its employees. These regulations allow local authorities to use all the established categories of investments, e.g. equities, bonds, property etc, and to appoint external investment managers who are required to use a wide variety of investments and to comply with certain specific limits.

2. BBB Priority: Excellent Council.

Financial

1. Cost of proposal: No cost

2. Ongoing costs: Recurring cost. Total fund administration costs estimated at £2.5m (includes fund manager/actuary fees, Liberata charge and officer time)

3. Budget head/performance centre: Pension Fund

4. Total current budget for this head: £31.6m expenditure (pensions, lump sums, admin, etc); £40.3m income (contributions, investment income, etc); £489.7m total fund value at 31st March 2011)

5. Source of funding: Contributions to Pension Fund

Staff

1. Number of staff (current and additional): 0.6 fte (current)

2. If from existing staff resources, number of staff hours: c21 hours per week

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Legal

1. Legal Requirement: Statutory requirement. Local Government Pension Scheme (LGPS) Regulations 2007 and LGPS (Administration) Regulations 2008

2. Call-in: Call-in is not applicable.

Customer Impact

1. Estimated number of users/beneficiaries (current and projected): 5,246 current employees; 4,522 pensioners; 3,859 deferred pensioners (as at 31st March 2011)

Ward Councillor Views

1. Have Ward Councillors been asked for comments? No.

2. Summary of Ward Councillors comments: N/A

3. COMMENTARY

3.1 At the meeting in May 2010, in a general discussion about Fund performance, some Members queried why, unlike most other Council pension funds, the Bromley fund currently lacked any exposure to property. This was seen by some Members as a potential disadvantage, particularly as they felt that property funds were recovering and in relation to the loss of rent yields. Other Members, however, felt that, in times of an economic downturn, the volatility of the property market could prove to be a large liability. The Sub-Committee recognised that further information was required to enable detailed consideration of whether or not to include property in the Bromley Pension Fund and agreed that "the Director of Resources be requested to submit a report to a future meeting setting out the issues for discussion on whether or not property should be included in the Bromley Pension Fund, including details of current activity around property by the fund managers and advice from the Council's actuary".

3.2 A further report was duly submitted to the September 2010 meeting comprising the views of Fidelity, one of the Fund managers, and Barnett Waddingham, the Council's actuary and adviser on pension fund matters. At that time, Fidelity put forward a number of reasons for considering investing in property, focussing mainly on the fact that property is a mature and established market, provides a relatively high and stable yield income, offers diversification benefits and has shown solid and stable performance against other asset classes. They felt that 2010 was an opportune time to enter the property market.

3.3 Barnett Waddingham agreed that property has a place in a Fund's Investment Strategy on diversification grounds, but did not agree that 2010 was a good time to get into property, mainly because the asset class has enjoyed a good run recently, as a result of which it may be difficult to get into pooled funds and some are holding high levels of cash. They were also concerned about high dealing costs and illiquidity issues and the fact that many banks have large amounts of property-related debt on their balance sheets. The Sub-Committee agreed that a watching brief should be kept on the property market and that a further report be provided after 1st April 2011.

3.4 Since September 2010, further advice has been sought from both the Council's current Pension Fund managers, Barnett Waddingham and the independent WM Company. Barnett Waddingham felt that they could not add to their original comments and were happy to reiterate the concerns summarised in paragraph 3.3 above. Baillie Gifford, Fidelity and the WM Company, however, have all provided a further update and information, as follows:

3.5 The WM Company has provided comparative performance returns to December 2010 across the Local Authority Universe for equities, bonds and property for periods up to 20 years, as follows:

Local Authority Universe (annualised)	1 Year	3 Years	5 Years	10 Years	20 Years
	%	%	%	%	%
Total Equities	16.4	2.9	5.8	4.3	9.5
Total Bonds	8.9	6.9	4.7	5.6	8.3
Total Property	11.8	-6.2	-1.0	5.9	7.4

Over the latest year, property has made a strong recovery from the global downturn of 2008. This has, however, not been enough to bring the performance back to a positive return over the 3 and 5 year periods, with property returns lagging way behind those of equities and bonds in those periods. Although property returns are the best over 10 years, equities and bonds have both outperformed property in the longest measured period, 20 years. The WM Company advises that the average property weighting of local authority funds at the end of December 2010 was 6.6% and roughly 90% of funds had a property allocation, with the smaller funds tending to invest via pooled funds.

3.6 Baillie Gifford does not have a “house” view on property as such, but has provided brief comments, as follows.

“Commercial property investment has often been viewed as a middle ground between equities and bonds in terms of its risk and return profile. On the one hand, it offers a relatively stable income stream and hence has bond-like characteristics, whilst of the other hand it should offer some link to economic growth in a similar way to equities. Over the period 1971-2006, property delivered a real return of 5.2% p.a., which was between the returns from bonds (3.9%) and equities (7.1%), with the property return being largely due to rental yields, rather than rental growth and revaluations. Historically, one of the challenges of investing in property has been the illiquidity and the large sum of money required to invest directly. Turnover costs and management fees are also a consideration and, based on discussions with property managers, we estimate that turnover costs are roughly 1.0% to 1.5% pa and management fess are between 0.5% and 1.0%. Annual management fees can be dependent upon the size of investment made, so a large institutional investment could see management fees negotiated as low as 0.4% pa. Additional consideration must be given to the reinvestment of income returns from commercial property investment and the periodic rebalancing of portfolio weightings. It may not be possible to reinvest cash distributions back into commercial property quickly or cheaply, which could result in dilution or cost inefficiencies.”

3.7 Fidelity are somewhat more upbeat about investment in property. On the one hand, they point out a number of attractions, including good investment returns, diversification, good income yield, a secure capital base and inflation protection. On the other hand, they list a number of disadvantages, including illiquidity, the possibility of tenant default / vacant assets, the highly cyclical nature of property as an asset class, large transaction sizes and costs and a less effective hedge against high inflation. In Fidelity’s view, the prime property market has recovered and is now fairly valued and now is an opportune time to enter that market.

3.8 Bromley’s Pension Fund is relatively small (currently valued at around £490m) and, in the view of officers, it would not be appropriate to hold individual properties directly because of the low number of physical assets and liability risks. Property investment would require the use of some type of pooled vehicle.

3.9 Officers are of the view that the fund’s performance returns in the short, medium and long-term have been sufficiently strong to more than justify the existing fund management strategy and feel that a change is not required at this time. Elsewhere on the agenda is the usual quarterly report that summarises the performance of Bromley’s fund relative to other pension funds. This shows the very strong returns that have been delivered without the use of property. Members of this Sub-Committee have adopted a strategy of predominant equity exposure focused on gaining results through market and stock selection. This has delivered high returns but with variation between years. Members have been willing to stick with this strategy to deliver the best long-term returns and have not sought to diversify and to heavily invest in assets that do not correlate to equities to smooth between years, potentially at lower longer term return. The fund currently uses gilts as a diversification strategy that allows managers to have reasonably liquid investments available to respond to changes in market conditions. Property would not provide anything like the current level of flexibility and liquidity.

3.10 The key actuarial assumptions in valuing the fund as at 31 March 2007 and 31 March 2010 were:

Financial Assumptions	**Nominal**	**Real**	**Nominal**	**Real**
Future investment returns	**% p.a.**	**% p.a.**	**% p.a.**	**% p.a.**
	2007	**2007**	**2010**	**2010**
Equities/absolute return funds	7.6	4.3	7.5	4.0
Gilts	4.7	1.3	4.5	1.0
Bonds & Property	5.4	2.0	5.6	2.1
Discount rate	6.9	3.5	6.9	3.4
Pay increases	4.9	1.5	5.0	1.5
Price inflation	3.4	-	3.5	-
Pension increases	3.4	-	3.0	(0.5)

It is likely that any move from equities to property would lead to a reduction in the valuation of the investment returns of the fund and a requirement for the Council to increase the employers' contribution, resulting in a higher charge to the revenue budget.

4. POLICY IMPLICATIONS

4.1 The Council's Pension Fund is a defined benefit scheme operated under the provisions of the Local Government Pension Scheme (LGPS) Regulations 2007, for the purpose of providing pension benefits for its employees. These regulations allow local authorities to use all the established categories of investments, e.g. equities, bonds, property etc, and to appoint external investment managers who are required to use a wide variety of investments and to comply with certain specific limits.

5. FINANCIAL IMPLICATIONS

5.1 None at this stage.

Non-Applicable Sections:	Legal and Personnel Implications
Background Documents: (Access via Contact Officer)	LGPS Regulations 2007 & LGPS (Administration) Regulations 2008.